# THE LATE FINANCIAL CRISIS.

BY HENRY CLEWS.

THE phenomena of a volcanic eruption or of a great earthquake are eagerly investigated by the men of science for what light they may cast upon the workings of the laws of nature. Not less reasonable may it be for the student of economics to avail himself of periodic financial upheavals for acquiring a broader judgment upon the laws of finance. For, as certainly as inorganic nature is governed by unchanging laws, are the exchanges of the products and services of mankind controlled by fixed natural ordinances, which ignore and finally supersede all the conventional arrangements by which society attempts to regulate its commercial intercourse.

It cannot be said that crises antecedent to the recent one have taught all that can be learned from such events. The late derangements have a special significance from the fact that, whilst the instrumentalities of finance remain virtually the same as they were under former panics, yet the conditions to which they are now applicable differ widely from those of previous periods ; and that circumstance suggests a probability that existing arrangements may be found imperfectly adapted to current requirements, which is one of the main conclusions I hope to establish.

First of all, then, what are the phenomena with which we have to deal ? (1) A sudden, extreme, and almost simultaneous fall in the prices of securities in both New York and London. (2) The antecedent symptoms of the break were apparent in some weeks of steady realizing upon corporate issues at both those centres, attended with the return from London to New York of a large amount (estimated at 10 to 12 millions) of railroad stocks and bonds. (3) This selling was stimulated by stringency in money in both cities, the Bank of England advancing its minimum rate of discount from 5 to 6 per cent., while the reserves of the New York

Associated Banks fell 3½ millions below the legal minimum. (4) At this stage came rumors that a large London banking-house was in trouble, the extraordinary negotiation of a loan of 80 millions of francs by the Bank of France to the Bank of England, renewed large shipments of American securities from London to New York, and a condition of the local loan market which induced the New York Clearing-House to authorize the issue of Clearing-House certificates to its members—an expedient never resorted to except under grave emergencies. (5) A few days later came the explanation of the London rumor and of the extraordinary precautions so suddenly taken by the Bank of England and by the New York Clearing-House in an announcement that the great house of Baring Brothers was unable to provide for over thirty millions sterling of commitments, and that the house had been protected by the intervention of the Bank of England, conjointly with a syndicate comprising several of the leading banking-houses of London and of the provincial cities. (6) To better enable the Bank of England to meet all possible derangements arising from the troubles of the Barings, the British government authorized the bank to make, if found necessary, a special issue of notes, without the legally-required security of specie, the amount and conditions of which authorization have not yet been made public. (7) Following these extraordinary measures of protection at the two financial centres, there was a marked recovery of confidence in London, and a few days later the Bank of England reduced its rate of discount from 6 to 5 per cent., with the ample reserve of 45.27 per cent.; whilst in New York there was a transient advance in the prices of stocks, followed, however, by a reaction and an increase of monetary stringency, which caused much commercial prostration and produced a serious crop of failures among mercantile, manufacturing, and banking establishments ; these effects being especially severe in New York and Philadelphia.

Inquiry into the occasion of these extraordinary conditions will show that they are attributable to two entirely distinct sets of causes ; one set being connected with the development of certain departments of enterprise and the negotiation of fiscal undertakings, and the other having to do with the financial instrumentalities through which such operations are effected. I propose to discuss these causes separately.

The wave-law appears to play a part in human activities as important as the place assigned to it in the physical sciences. Material enterprise constantly oscillates between the extremes of quiescence and excitement, of conservatism and speculation, of contraction and expansion. The revolution of commercial and industrial methods consequent upon the introduction of steam and electricity has, however, so far as respects trade and manufactures, greatly diminished the violence of these oscillations and lengthened the period elapsing between their extremes. Steam has shortened the period of production and the time of transferring products from market to market, while the telegraph has virtually made the world one vast mart, with instant communication between all its parts. This has maintained, for the last fifteen years an unprecedented steadiness and uniformity in prices; which, by diminishing the risks of business, have proportionately reduced its exposure to great commercial derangements. Hence the late crisis found the trade of the country in a generally healthy condition, and what injury has indirectly befallen commerce is due almost entirely to the disruption of credit from purely monetary and financial causes.

The chief source of the recent troubles has arisen in connection with enterprises which admit of a liberal application of speculative methods; and among such enterprises the creation of railroads stands foremost. The panics of 1873 and 1884 were chiefly due to an excessive diversion of capital into the building of railroads, and also to the fact that the new companies were organized upon a grossly speculative and inflated basis. Within the last ten years we have had two distinct periods of over-construction of railroad. In 1879 the United States had 84,393 miles of road; in 1884 the mileage had risen to 125,152—an increase during the five years of 40,759 miles, or 48.3 per cent. This expansion was about four times the rate of increase of population during that period; which, without further evidence, may be taken as warranting the conclusion that this five-years' construction was out of all proportion to the growth of commerce and to the required increase of transportation facilities during that time. Had this immense over-construction been associated with sound methods of capitalization, the investors might have afforded to wait a few years, when the trade of the country would have grown up to the measure of the

enlarged carrying capacity, and reasonable returns would be forthcoming. But the general radically-defective State laws relating to the organization of railroad corporations not only permitted the capital stock to be issued virtually without consideration, but also made it possible to issue mortgage bonds without getting an equivalent value in construction. It thus came to pass that, whilst the forty thousand miles of new road were capitalized and bonded for a total of about $2,720,000,000, the true amount of actual capital invested against these issues was probably considerably less than half that sum. These were the conditions that brought about the crash of 1884; which not only necessitated a sweeping reconstruction of the new balloon enterprises, but involved the stock of the older companies in a shrinkage of market value from 80 points, the average best prices in 1883, to 40, the average lowest prices in 1884.

It would seem that such a notorious result of speculative enterprise should have sufficed, if not to prevent a repetition of like extravagance, yet at least to postpone it until the disgrace had been forgotten. And yet, following the collapse of 1884, only one year of contraction of construction elapsed. In 1886 the furore reappeared, and in that year 5,877 miles of road were built; in 1887, 14,393 miles; in 1888, 6,277 miles; and in 1889, 6,268 miles—a total of 32,815 miles within four years. This increase is at the rate of 25.7 per cent. upon the mileage existing in 1885, which is about two and a half times the rate of the concurrent growth of population. It will hardly be pretended that this increase of construction was justified by a corresponding growth of trade within the period; for that would be to maintain that the national production had progressed at nearly three times the rate of the national population—manifestly an improbable, if not an impossible, proposition. It is true that the tonnage of the roads showed even a higher proportional gain, during these four years, than the mileage; but it is to be remembered that all the transportation connected with the building of the 32,815 miles of road is included in the returns of tonnage.

It is something in favor of the over-construction of the last four years that it has not run to the same degree of excess as was reached in the period from 1880 to 1884, inclusive; but that plea is more than counterbalanced by the fact that the second period of excess came so immediately on the heels of the previous one

as to leave no interval for the repair of the crash of 1884 and for the distribution of the mass of securities issued previously to that culmination. Virtually, indeed, the two periods of excessive railroading run into each other and constitute one prolonged era of overcreation of speculative enterprises. In this very important sense the crisis of 1890 is the culmination and the winding-up of ten years of vicious financing, involving the issue of $4,609,000,000 of securities and the doubling of the railroad investments of the United States.

Among other causes contributing to the recent upheaval must be cited the injurious bearing of the Inter-State-Commerce Act upon the railroads. It may be safely stated, as the common opinion of railroad managers, that the result of that law has been to embarrass the effective working of the roads, to hinder economies in management, to diminish earnings, and to increase working expenses. Still more unjust and still more obstructive have been the restraints of the Granger laws and the intrusions of State commissioners. In the States most addicted to these interferences of State authority, several of the oldest and best-established companies have been brought dangerously close to the verge of bankruptcy, while the market value of their shares has been reduced by nearly one-half. Whatever any interest may have to urge in defense of this crippling of the chief instrumentality of commerce, the fact is not to be questioned that the impairment has been an important factor in producing the fundamental financial derangements from which the country has been and is still suffering.

The extraordinary creation of new buildings may be regarded as another branch of the speculative inflation. In nearly all parts of the country there seems to have been, in respect to both dwellings and business structures, a large anticipation of the future wants of population. The following statement of the number and value of new buildings officially registered in New York city during the first eleven months of 1890, compared with certain preceding years, may suffice for illustration on this point :

| Year. | Number. | Value. |
|---|---|---|
| 11 months of 1890 | 3,363 | $71,100,000 |
| 12 months of 1889 | 4,207 | 69,500,000 |
| 12 months of 1885 | 3,368 | 45,400,000 |
| 12 months of 1881 | 2,668 | 43,400,000 |
| 12 months of 1880 | 2,252 | 29,100,000 |

Among the minor influences contributing to the results under review should be noted the locking-up of several millions of silver bullion, in anticipation of the operation of the new Silver Act, which diverted an equal amount of loanable funds from ordinary market use and aggravated the stringency of loans at the incipiency of the crisis. The enactment of the McKinley tariff also contributed its quota to the general demoralization, by causing importers to make large prepayments of duties; which involved the double misfortune of transferring several millions of cash from the banks to the treasury and increasing the demands of the importers for bank accommodation. Thus, concurrently with the culmination of a radical chronic disease, came accidents which seriously disabled Wall Street for resisting the mischief.

Thus far, I have enumerated, as the causes of the financial crisis, only factors connected with domestic affairs. In truth, however, a large measure of its aggravation must be charged to the account of the deranged condition of finance in London. Not only has Great Britain participated very largely in recent American railroad speculations, but she has, for the last three years, indulged in a mania of speculative financing surpassing all precedent. "Finance" companies, "trust" companies, and "investment" companies—possessing just enough of capital and of the deceptive sanction of high names to attract unwary investors—have created a host of enterprises calculated to benefit promoters rather than participators, with the result of an immense issue of new "securities,"—by a generous euphemism so-called. The total amount subscribed for these new corporations and for public loans from the beginning of 1888 to the end of October, 1890, appears from the London papers to have been about £485,000,000. The principal items of this total are enumerated in the following approximate statement:

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|---|---|
| Outstanding South American loans | £145,000,000 |
| Argentine Republic cedulas | 100,000,000 |
| South American railroads | 58,000,000 |
| South African mines | 10,000,000 |
| Nitrate mines | 3,500,000 |
| Trust companies | 60,000,000 |
| | £376,500,000 |

It will thus be seen that, of the total subscriptions of capital within the three years, £376,500,000 was for purposes external to Great Britain; besides which there are unspecified large subscriptions for other foreign and for colonial undertakings,

aggregating probably not less than £50,000,000. It would therefore appear that, of the total £485,000,000 of new creations, approximately £366,000,000 has been for external purposes, while less than £120,000,000 has been subscribed for the promotion of strictly home enterprises. This immense creation of new undertakings is asserted by English statistical authorities to have been very largely in excess of the concurrent increase of British wealth. When, therefore, it is considered that three-fourths of the subscriptions were for foreign purposes, it is at once apparent how violent must have been the strain upon British finance to provide for these vast commitments, and how much must still remain to be endured before this oppressive oversupply of new issues can be finally distributed. The extent to which not only large promoting companies, but even banking-houses of high repute, have been involved in floating these new issues is illustrated by the fact that the Barings were found to have, at the time when their embarrassments were exposed, over £30,000,000 of outstanding commitments, chiefly connected with their operations in South American loans, most of which advances rested upon the most slender chances of repayment. The simple mention of these facts suffices to demonstrate that the whole system of British finance must have been sapped and drained to an extent far exceeding all experience in modern eras of speculation.

From the foregoing survey it is plain that the underlying causes of the crisis have consisted almost entirely in an overcreation of new and largely doubtful enterprises. These excesses set in almost simultaneously in the United States and Great Britain, and they culminated together. Our share in the inflation may be approximately stated as covering about $2,000,000,000 ; that of Great Britain about $2,400,000,000 ; with the intrinsic merits of the investments perhaps preponderating in favor of the United States, as most of our new railroads have the promise of ultimately becoming remunerative, as commerce develops.

The violently irregular movements reflected in the foregoing facts are a sad comment upon the lack of judgment among investors, and equally so upon the willingness of a class who control large amounts of capital and enjoy the confidence of the public, to misdirect the national earnings into unsound and wasteful ventures. But the more regretable such experiences may be, the more necessary does it become to devise every possible

means for limiting the disaster they entail. Certain consequences of these inflations are inevitable. The "water" must be squeezed out of the issues, and their value reduced to the standard of their true earning capacity. That means wholesale liquidation and large declines in the market value of the scrip; which, again, involves the disturbance of loans based upon the dubious collaterals, and frequently the failure of banks, bankers, or promoters who have committed themselves to the ventures; and these derangements almost invariably involve sympathetic injury to commercial interests which have no direct connection with such misdirections of enterprise. So much is inevitable. The disease is radical, and therefore can be cured only by a severe process.

But it is a question that deserves serious examination whether existing financial arrangements are of the form best calculated to tide over these convulsions with the least possible disturbance. The experiences of the last few weeks have afforded too much evidence that they are far from possessing such perfection. So far as respects England, the perils—so narrowly escaped by such extraordinary expedients as the Bank of England getting help from the Bank of France and procuring authorization to issue notes in disregard of law—have opened the eyes of the banking community, of statesmen, and of the press to the necessity for immediately broadening the powers of the national bank and alleviating the onerous restraints imposed upon it under Sir Robert Peel's Bank Act. What can be done to increase the elasticity of our financial instrumentalities? has become the most urgent question of the hour in this country. It would be fortunate if the judgment of the public on this question were commensurate with their anxieties. The truth must be confessed, however, that popular conceptions of the nature of the problem are so vague and wild that any remedy provided through legislation is likely to be of doubtful efficacy. Probably two-thirds of our people are persuaded that the whole evil lies in an insufficiency of currency, and hence Congress is distracted about the ways and means of indefinitely inflating the circulating medium.

If currency could have either prevented or cured the present unfortunate situation, there would have been nothing to complain about at this moment. For, according to the annual report of Secretary Windom, there was an

increase in the circulation in actual use, during the three months next preceeding the crisis, amounting to over 68 millions; which extraordinary inflation produced no perceptible effect whatever upon the universally stringent condition of the money market. For years past, the circulation has been increasing out of all proportion to the growth of population, the amount in actual use on October 1, 1886, having been $1,264,900,000, and on the 1st of October last $1,498,000,000, showing a gain of $234,000,000, or 19 per cent., within four years, which is double the ratio of growth of population. These facts prove that it was through no deficiency of circulation that the panic occurred or that it was not more easily held in check. It may well be asked what would have been the condition of affairs in London under the late upheaval, had that market been as directly dependent as this theory assumes on the volume of circulation, seeing that at the beginning of November the paper circulation of Great Britain was $10,000,000 less and the specie in the Bank of England $42,000,000 less than were those respective items ten years before. What support does the demand for a large continuous increase of the currency receive from the fact that England constantly is largely augmenting the volume of her business, with a stationary and at times retrogressive volume of circulation?

And the same question may apply with similar force to the circulation of the Bank of France (the only issuer of paper money in France), whose volume of outstanding notes last November was about the same as in that month of 1883. The notion that money is essential to all the transactions of business is productive of endless misconception about the workings of finance. Money is merely a tool for the *small* payments of society; while all the large transactions of trade and finance are settled by checks, notes, bills of exchange, or the transfer of book accounts; and it is exclusively these latter instruments that are concerned in the development and settlement of financial crises. In the use of these instruments of the *large transfers*, therefore, must be sought a revision which will secure better control over such convulsions as the one which has recently shaken the foundations of confidence on both sides of the Atlantic and among one hundred millions of commercial population.

Nevertheless, by a purely artificial expedient, money is made to play a very important part in disturbances of credit oper-

ations. The national banks of New York, at which the larger half of the whole banking operations of the country are transacted, are required by law and under threat of suspension to hold an amount of lawful money equal to not less than 25 per cent. of their net deposits. When the reserves trench upon this legal limit, the law compels the banks to stop lending, and the money that might be used for satisfying the wants of borrowers is kept idle at the bidding of authority. In this sense, at times and indeed too frequently, the matter of a few millions of money is invested with an almost omnipotent power over the negotiation of thousands of millions of credits ; and the whole machinery of finance is crippled because a handful of banks are deprived of the right to a proper use of their money. Public opinion blindly ascribes these congestions to "a scarcity of money," while in truth, the trouble comes entirely from an arbitrary and needless restraint upon the lending function of the banks. The operation of this reserve law has contributed more than all other causes to the panics and the periodic congestions that have made the oscillations of the New York market a byword and a marvel the world over.

It is not to be inferred from this that I in any measure underestimate the necessity of maintaining ample cash reserves : the only question is whether they shall be regulated by a cast iron law or by each bank for itself ; whether they shall be used when the emergency arises for which they are provided, or be kept idle in times of urgency, to the injury alike of the banks and the public. Herein, as I conceive, lies one serious source of the needless aggravation of crises, which ought to be remedied.

In various other directions, the national banks are placed under legal restrictions which impair their ability to take care of themselves and their customers in periods of disturbance. The banks are allowed to issue circulating notes only upon deposit of bonds the market value of which exceeds by 15 to 30 per cent. the amount of notes issued ; whereas the notes could be made absolutely secure by simply making them a first lien upon all assets of the bank, as well as upon the duplicate capital for which the stockholders are responsible in the event of the bank's failure ; in which event, the bonds now deposited against circulation could be converted into mobile and always readily available capital. The form of guarantee here suggested has a broader precedent in foreign banking systems than any other.

The banks are systematically embarrassed also by the clause forbidding their lending a sum exceeding one-tenth the amount of their capital to any one borrower. Conservative as this restraint may seem in theory, yet, in such large operations as have to be undertaken by the New York banks, it is found to be very decidedly otherwise in practice. It frequently prevents a bank from accepting a large sound loan, and compels it to divide up its advances among several smaller and weaker borrowers. In times of disturbed credit it often prevents a good customer from getting all the accommodation at his bank that he needs, and for the remainder throws him upon the tender mercies of others to whom his standing is unknown. Such a restriction is specially hostile to the interests of a city at which centre the larger transactions of the nation. More and more every year capital is concentrating into larger masses; and its owners require correspondingly increasing accommodation from the banks. Yet, owing to this 10 per cent. limitation, the lending ability of the national banks becomes increasingly inadequate to the borrowing requirements of large interests. The readiness of the Associated Banks to issue Clearing-House certificates in periods of danger is very largely explained by the fact that, as each bank is by law largely disqualified for dealing with important applications for advances, they find it necessary to consolidate their lending power, as a means of resisting the progress of demoralization and relieving the urgent wants of borrowers. In these and in other respects the rigidity of the national-banking system has become responsible for a serious inadequacy of our banking arrangements to satisfy our financial necessities.

The foregoing are only some of the many possible alleviations of the irregularities in the working of our financial system which are seriously retarding the progress of the nation. They are, however, all to which the necessary limits of my space permit reference.

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